

THE TAX CUTS AND JOBS ACT IMPACTS SETTLEMENTS OF SEXUAL HARASSMENT AND ABUSE CLAIMS

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The recently enacted Tax Cuts and Jobs Act eliminated a business expense deduction for settlements of sexual harassment and sexual abuse claims that are subject to confidentiality restrictions. Specifically, a “settlement or payment related to sexual harassment or sexual abuse,” and the “attorney’s fees related to such a settlement or payment,” are no longer a deductible business expense “if such settlement or payment is subject to a nondisclosure agreement.” IRC §162(q) (added to the IRC by §13307 of the TCJA). Section 13307 became effective on December 22, 2017.

This new Code provision raises many questions, which the IRS has not yet addressed, including:

What is the impact of IRC §162(q) on the settlement process for sexual harassment or sexual abuse claims?

Employers will need to weigh the additional costs of a nondisclosure provision, which include the tax on the settlement payment and related attorney’s fees, and the value of a nondisclosure provision to the employer with respect to the specific claim asserted by an employee. Rather than “boilerplate” in a settlement or separation agreement, nondisclosure provisions will need to be assessed on a case-by-case basis.

Attorneys for both employers and employees will need to track time separately for “attorney’s fees related to such a settlement,” since an employer may determine that a nondisclosure provision is an essential term of the settlement, and then neither the employer’s nor the employee’s attorneys’ fees related to the settlement will be deductible.

What attorney’s fees are “related to such a settlement”?

Certain fees appear to be related in most circumstances: time spent in preparing for and attending a mediation or settlement conference; in negotiating a settlement; and in drafting and revising a settlement agreement. Whether time expended in initial investigations; drafting and responding to demand letters that result in an early settlement; or other fees will be considered “related” will depend on the position the IRS takes in enforcing and interpreting IRC §162(q).

When sexual harassment or sexual abuse claims have been asserted along with other claims, will the entire settlement payment be nondeductible? Will all of the attorney's fees related to the settlement be nondeductible?

The practical answer to this question is to expressly and realistically allocate the settlement payment among the claims asserted. Employment attorneys have experience in allocating settlement payments among types of relief that have different tax consequences (e.g., among backpay, attorneys' fees, and emotional injury damages in settling employment discrimination claims, or among overtime, liquidated damages and attorneys' fees in settling FLSA claims). This will be another situation in which judgment in making the allocation and documentation of the basis for the allocation will be required, given the risk that the allocation may be challenged. When no sexual harassment or sexual abuse claims have been asserted, will severance payments made pursuant to a separation agreement that includes a broad, general release and a nondisclosure provision be non-deductible?

The answer to this question must await IRS guidance. It is possible that the IRS could take the position that a general release of employment claims includes sexual harassment or sexual abuse claims, so that a separation payment necessarily is in part related to the release of such potential claims. The counter argument is that IRC §162(q) refers to "any settlement or payment related to sexual harassment or sexual abuse," and that payments made when an employer is not aware of any sexual harassment or sexual abuse claim are not within the scope of that provision.

In this situation, employers may want to consider asking employees for representations both that the employee has not asserted and has no knowledge of any such claims and that the agreement is therefore not a settlement of such claims, but still including an express release of sexual harassment and sexual abuse claims in the release provision of the agreement. A more risk adverse approach is to draft nondisclosure and non-disparagement provisions in separation agreements that expressly exclude claims of sexual harassment and sexual abuse.

Bryan Cave LLP has a team of knowledgeable lawyers and other professionals prepared to help employers assess their obligations under the Tax Cuts and Jobs Act. If you or your organization would like more information on the Tax Cuts and Jobs Act, how to structure any settlement, or any other employment issue, please contact an attorney in the Labor and Employment practice group.

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